

INSTITUTIONAL AND MARKET DRIVERS TOWARDS  
A EUROPEAN CAPITAL MARKETS UNION

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Abstract

*The main purpose of this paper is to make an overview of the development of the institutional and market framework toward the full integration of the EU capital markets. It analyzes the progress at EU level for overcoming the still fragmented capital markets in the aftermath of the global financial and economic crisis and the current initiative for the creation of EU capital markets union. Besides, our paper evaluates the market initiatives driving the completion of the pan-European capital markets.*

Keywords: EU, capital markets, European financial integration, standards, tax policy, European Commission

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## 1. Introduction

Theoretically the effectively functioning capital markets assist in the optimum distribution of capital within EU and are conducive to boosting competitiveness and the access to venture capitals. Among its main advantages are the following:

- profitability and effectiveness of financial transactions and development of a reliable base for trade clearing and settlement and depository services;
- distribution of risks and effective utilization of financial resources;
- effective evaluation and measurement of risks in financial transactions;
- overcoming the asymmetry in the disclosure of information and the problem principal – agent in the intermediation in the financial sphere;
- improving financial stability in EU and raising the inflows of foreign capital in EU.

Financial integration strengthens the level of financial development and intermediation and contributes to the fulfilment of the goals set in the revised Lisbon strategy and Strategy “Europe 2020” *for a smart, sustainable and inclusive growth*, leading to more jobs and opening up of business opportunities. The European Commission drives the process of integration in the financial sphere of the EU member states by the implementation of various regulatory acts that settle the relations between the parties on the capital market (Hristova-Balkanska, 2012).

The achievement of the main goal – an integrated capital market – requires focus on several fields, to which the institutional initiatives should concentrate their efforts according to the European Commission:

- development of integrated financial infrastructures – reaching high level of technical and technological compatibility among national securities settlement systems and implementation of adequate mechanisms to combat money laundering and fraud;
- development of mechanisms for maintenance of competition on the financial markets in EU;
- tax treatment – the differences in tax treatment appear to be a serious barrier to the effective distribution of financial resources in EU.

The lack of a high degree of market integration due to remaining regulatory, administrative, tax restrictions as well as differences in the financial systems and the corporate governance systems show that the capital markets in the EU member-states are still not fully integrated.

The general conditions for a fully integrated financial market in EU are the following.

*First, there are needed the premises for integrated financial infrastructures.* Stock exchanges and the markets of derivative instruments are undergoing transition to common securities trading, clearing and settlement systems. The main engine driving these changes resides mainly in the market forces. One of the basic issues in this field is related to overcoming the legal restrictions in front of the payment and settlement systems. The Settlement Finality Directive predetermines the implementation of safe operational mechanism for limiting the systemic risk.

An important element for the mitigation of this risk is the application of the requirements for collateral in securities transactions. One step further in the integration of capital markets is the establishment of links (both technical and operational) between depositories of securities within the EU. Further measures are needed in order to guarantee the safety of the capital markets against money laundering attempts and frauds.

*Second,* the policy for preservation of competition requires strict application of the norms and the requirements of the Treaties of Rome in the field of dominant position abuse, mergers and acquisitions, state aid measures. The European Commission encourages an approach of cooperation among banks and the other financial institutions conducive to creation of integrated trading platforms, payment and settlement systems. On the basis of the Economic and Monetary Union in the integrated market heightening of competition will be an important driver for change, together with the interventionist policy of the regulatory institutions at micro and macroeconomic level (Hubenova – Delisivkova, 2012).

*Third, as regards the tax policy,* it should be applied in a manner leading to harmonization of tax treatment of incomes, generated on the capital markets in the EU. This leads to further reduction of risks, relating to tax treatment avoidance and distortion of market stimuli for investments and savings.

In the following sections we will bring to the forefront the institutional initiatives towards an EU capital markets union and the market drivers toward a Pan-European capital market.

## 2. Institutional initiatives towards an EU capital markets union

### 2.1. The general framework

The Financial Services Action Plan (FSAP) of EU (1998-2003) established the strategic goal for the creation of a single market of financial services on the organized financial markets of the EU by provision of possibilities and attraction of private equity capital under competitive conditions and equal access of investors and intermediaries to all markets and provision of financial services without barriers of legal or administrative origin. FSAP established about 42 legal measures encompassing accounting and audit, banks and financial conglomerates, company

law and corporate governance, financial markets infrastructure, insurance and occupational pension insurance, securities markets, retail services, investment funds and taxation.

The main challenges following 2008 crisis are that the conditions for trade become more complex, while market regulations lag behind the realities. As a result, the European Commission undertook thorough revision of the legal framework of the capital markets after 2008 global financial and economic crisis in view of strengthening the confidence of investors, decrease of market and systems risks, increase of the effectiveness of the financial markets and fall in costs for the market participants.

One of the main problems, which prompted the regulatory changes, is the lack of equality between the regulated and alternative trading systems. The new market structures as the platforms for derivatives trading should be subject to the same strict regulatory requirements as the regulated systems in terms of transparency and protection of investors. The regulation of the alternative trading systems and the requirement for their notification to the competent authorities meets the commitments, undertaken within the framework of G-20 forum, all standardized over –the counter (OTC) derivative contracts to be traded on a stock exchange or exchange-traded electronic systems and their clearing to be realized through a central counterparty (CCP). This is expected to improve market transparency, mitigation of systemic risk and protection against market abuse.

Another main issue is related to the SMEs sector, facing difficulties in the access to the financial markets in view of the high costs for Initial public offerings (IPOs) of securities and lack of secondary markets liquidity of their shares. Thus, the new regulatory framework exactly differentiates the SMEs growth markets by encouraging the development of specialized segments on the capital markets in the EU for SME financing.

The integration of the EU financial markets cannot be viewed as an end in itself. All active policies, instruments, legal acts and financial measures in the EU should be activated to reach the targets and objectives outlined in Strategy “Europe 2020”. The main priorities are attaining an intelligent growth based on knowledge-driven economies and innovations; sustainable growth through effective utilization of resources in view of boosting the economic competitiveness and growth through employment and territorial cohesion.

The idea for the EU capital markets union (CMU) has been introduced by Jean-Claude Juncker in July 2014 in a report “A New Start for Europe: My Agenda for EU Jobs, Growth, Fairness and Democratic Change” (Juncker, 2014) and further supported by the Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill. Nevertheless, according to Steven Maijoor (Maijoor, 2014), “CMU remains largely a concept under construction”. It can be considered as a response to the slow credit growth in the EU in the aftermath of the

global financial and economic crisis and the European debt crisis. In the long term CMU could be expected to make the European financial system more efficient and resilient based on greater diversity through banking and non-banking sources of finance.

Despite the single currency and the years of harmonizing legislation and regulatory framework, the European capital markets remain significantly fragmented. After the successful launch of FSAP in 1998 and the aim to boost integration in the wholesale securities markets, the process was protracted and reversed with the onset of the global financial and economic crisis. Thus the idea for European CMU is not a new one, but a continuation of the strategic aims of the Single Market Act of 1986 and the FSAP of 1998 to harmonize financial regulation and take advantage of the established European System of Financial Supervision and European Securities Market Authority (ESMA) introduced in 2009. The broad rulebook approach, pursued by the Markets in Financial Instruments Directive, the European Market Infrastructure Regulation and Alternative Investment Fund Managers Directive etc., is relatively new as is the use of regulations as opposed to directives.

Considering the US experience, for a successful currency union essential conditions are effectively functioning fiscal and capital markets union (Joseba *et al.*, 2014). A fiscal union improves risk sharing via net fiscal transfers across regions. The cost of joining a currency union will tend to decrease with fiscal integration or the availability of public or private mechanisms to smooth out diverse shocks through regional transfers (Kenen, 1969). On the other side, a capital markets union improves risk sharing via financial markets – through equity and fixed income flows apart from cross-border bank flows and will tend to lower the cost of joining insofar as it allows countries to smooth consumption in the face of idiosyncratic shocks (Mundell, 1973; Buitert and Sibert, 2008). Effective financial market risk sharing relies on integrated capital markets.

The deleveraging process of banks in the EU led to the current scarcity of long-term financing. The tighter regulations have focused bank activities in home markets leading to a reduction in cross-border financing and fragmentation of the single market, which decreased the availability of funding and drove up the cost of capital. Against this background there are new opportunities for other intermediaries to complement the role of banks by channelling financing to long-term investments in a more balanced way. The CMU can be regarded as a process to identify the remaining capital markets barriers and the spheres of underdevelopment, overcoming of which can boost long-term investments in Europe (Association of Financial Markets in Europe, 2014).

## 2.2. Main areas of policy initiatives

The agenda for the development of the CMU is connected with the following possible areas for policy initiatives (Veron, 2014):

- Regulation of securities and development of standards for high quality securitization

According to the recommendations of FESE (2014), the EU has to adopt a target for European capital market's share of financing the economy – as an example an explicit political objective of stock market capitalization to account for 100% of EU GDP by 2020 in order to increase the supply and demand sides of the market. According to a research by Deloitte (2009, 2014) the most important factors for the development of an active market for IPOs are: interest of investors in acquisition of equity capital in public companies (over 90% significance); economic stability (60%), availability of hi-tech companies (50%). The forecasts according to the report are that in the period following 2013 the stock exchanges with the greatest prospects for attraction of companies supported by equity and venture capitals will be NASDAQ (87%), NYSE (39%), Shanghai (33 %), London AIM (26%), Euronext (14%) and Deutsche Boerse (4%). The Deloitte research outlines that confidence in the US venture capital industry is on the rise due to the robust IPO markets and the high innovative capacity of SMEs in the US.

- Initiatives for ease of SMEs to access to equity and venture capital financing

In the field of SMEs actions have been undertaken by the equity and venture capital funds (EVCs) to invest in the EU member states without facing barriers or additional requirements. These funds face significant difficulties raising capital in cross-border context due to the differences in the regulatory regimes and tax barriers. An important priority is widening the geographic base for raising and investing capital by the EVCs in view of the creation of the single internal venture capital market in EU. With the new regulatory framework (the Regulation on the European Venture Capital Funds) the expected consequences are the creation of more and better capitalized EVCs, more opportunities for financing innovative SMEs and rise in competition. The cross-border activities of EVCs may play a significant role in the economic recovery and growth, innovativeness and levels of employment in EU.

- Industrial leadership of innovative SMEs

*The Framework Programme for Research and Innovations – Horizon 2020* (European Commission, 2011) sets the priority for industrial leadership of innovative SMEs, which undertake research and innovations by providing an adequate level of financing. The instruments envisaged in the Programme will be

directed to support the development of innovative SMEs by evaluating the potential of each project. The financial instruments for SMEs are subdivided into three types: financial instrument for innovative research by small businesses; instrument encouraging creation of new SMEs in hi-tech fields by connecting research centres in Europe, and financial instrument for venture capital financing.

- Common and reliable standards for cross-border information and research on SMEs

The markets need to be open for all investors and treat them equally without segregation on pan-European level, thus boosting innovation as well as regional and local employment. There is a current market failure in the provision of financial analysis on smaller companies. A proposal of FESE (2014) is the establishment of centralized SME rating and information database by EU member states, and research and company information to be provided by a consortium of industry players in collaboration with the public sector. The SMEs should be made more visible to pan-European investors through creation of SMEs index as an asset class at European stock exchanges. The improved regulatory framework for SMEs include amendment in the Capital Requirements Directive to lower the capital requirements related to credit risk for exposures to SMEs. On the other hand, the Market Abuse Regulation adapts the disclosure requirements for issuers on SMEs growth markets. With amendments in Prospectus Directive proportionate disclosure regime will increase the efficiency of the regime by reducing the administrative burdens for issuers and preserve a sufficient level of investor protection. The amendments to the Transparency Directive will facilitate SMEs access to IPOs market segments by abolishing the requirements to publish quarterly financial information and reduce the administrative burden for listed companies. The revised Accounting Directive provides for a simplified accounting regime for micro-undertakings, allowing member states to exempt firms producing certain notes to the financial statements.

- Development of an European market for private placements by standardized prospectus template (as in the US).

Advantages for SMEs in this respect are that they will not have to register their bond issues with the securities regulator, which significantly reduces issuance costs. In most EU member states this market segment is small with the exception of Germany and France (around EUR 15 billion of issuance in 2013). As a result many EU companies turn to US private placement market to issue bonds. The main goal is the development of common market practices, principles and standardized documentation for EU wide private placement market. Thus EU could follow US practice and introduce a lighter regulation of firms that only wish to raise a small amount of money.

➤ New investment fund framework through the European Long-Term Investment Facility

It is necessary to develop an integrated approach to the finance of growth through a thorough EU investment policy to fully mobilize capitals for long-term investments (Gualateri, 2014). The creation of European long-term investment funds would lead to investments in illiquid assets and would help to boost the other capital markets. These funds must invest a substantial proportion of their portfolio in unlisted companies or projects, infrastructure or other real assets, that need long-term capital to develop. The introduction of liquidity requirements for different financial market players may discourage investments in less liquid assets and block several possible financing channels. The challenge is to achieve the regulatory goals for greater macroeconomic and financial stability and global regulatory convergence in a way that minimizes any disincentives for financing productive long-term investments. The long-term investment funds (LTIF) will be open to both professional and retail investors and trading in assets other than long-term investments will be permitted to a maximum threshold of 30 % of the fund's capital. The authorization of the European LTIFs will be valid for all member states, while ESMA will keep a central public register of each LTIF. The creation of European Venture Capital funds and European Social Entrepreneurship Funds plays a significant role as drivers for long-term financing. The Competitiveness of Enterprises and SMEs Programme of EU (COSME) also plays a key part in attracting institutional investors to the venture capital industry by establishing cross-border pan-European funds of funds (FF).

➤ Prudential regulations of institutional investors as insurance companies and pension funds

The Solvency II Directive for insurance companies and the Occupational Pension Funds Directive should be reviewed accordingly in respect of the capital requirements for globally active pension and insurance firms. Institutional investors in EU hold an estimated total of EUR 13.8 trillion of assets, equating to more than 100% of EU GDP. Globally, circa 56% of large pension fund assets are in fixed income and cash, 28% in equity and 16% in alternative investments. They buy a significant amount of sovereign debt, which may crowd out investment in public equity and public corporate debt. Yet historically equities outperform bonds over the longer term. Given the long-term horizon of pension funds, a small portion of funds being available to SMEs financing would trigger a huge potential for innovation and growth. Pension funds capital rules differ across member states and differ from those of insurers to take into account the different risks associated with occupational pension funds. It will be vital any new prudential rules for occupational pension schemes not to discourage sustainable long-term financing.



- Regulation of accounting, auditing firms and other financial intermediaries

It is necessary to increase the harmonization and transparency of the financial intermediaries. Fair value accounting principles can enhance the consistency of financial information since they show the market value of assets and liabilities. Market consistent valuation may encourage long-term investments and increase the risk exposures (especially in equity). The decision to adopt International Financial Reporting Standards (IFRS) at EU level in 2002 was a significant step forward to harmonization of accounting practices but currently IFRS are mandatory only for listed companies in EU. They have led to a reduction of costs and created much needed transparency and compatibility for investors in Europe (Hoogervost, 2014). Further step would include creation of EU regulator for the large audit firms at EU level and establishing EU Chief Accountant with authority over IFRS enforcement.

- Heightened supervisory framework for financial infrastructure firms as central counter-parties that support market integration

The regulatory framework that applies to financial market infrastructure in EU is largely harmonized, yet some infrastructure intermediaries as the central counter-parties (CCPs) remain subject to national frameworks of supervision, which results in serious barriers to the integration of the EU capital markets in cross border context. This leads to proposals for the establishment of global supervisor and regulation authority over the intentionally active CCPs.

- Harmonization and improvement of insolvency and corporate restructuring framework

Insolvency frameworks tend to diverge considerably in the EU member states and create a significant barrier for the development of securitization and increase the uncertainty among investors and other stakeholders. Out-of-court restructuring is underdeveloped in Europe as compared to the situation in the US. Bankruptcy, securities and company legislation are insufficiently aligned in EU and retarded the progress toward the integration of EU capital markets. The legal barriers outlined in the Giovannini Reports (2001, 2003) need to be dismantled to contribute to the objective of safe and efficient post-trading environment in Europe. Rules should be implemented preventing the loss of client securities by imposing segregation of client assets. The existing conflict-of-law rule of the Financial Collateral Directive should be extended to all areas of holding, acquisition and disposition of securities. The European Markets Infrastructure Directive calls for increasing the number of derivative transactions to be cleared via CCPs with the

requirement to post collateral. This would require free flow of collateral across entities and borders and standardization of the forms of collateral.

- Harmonization or convergence of tax policies that specifically affect financial investments

The differences between national tax regimes for equity and debt products, which generally favour debt, represent an obstacle for the trans-border capital market integration. The European Commission will monitor the issue through country specific recommendations to incentivise equity investments, in particular in member states with high debt bias in corporate taxation. The International Monetary Fund (IMF) (AFME, 2014) advises achieving equal tax treatment for debt and equity by reducing tax deductibility of interest or introducing similar deductions for equity returns. Any new tax policy (for example the financial transactions tax) that would discourage investors should be avoided. The lack of harmonization of taxation and national reporting complicates financial analysis especially for smaller companies since the willingness of investors to research these companies tends to be low. Many member states have introduced a variety of incentives to increase long-term savings in respect of pension-related savings. Besides, some member states apply dual income tax system where capital income is generally taxed separately at a lower rate than other sources of income. Yet the multitude of different national taxation rules may create arbitrage possibilities. Another disincentive for cross-border equity investments is the withholding tax on dividends. The option for reform would be the abolition of this tax.

- Development of capital market culture through financial education

In the US, the public opinion for the capital markets remains positively associated with entrepreneurial dynamism. Public-private cooperation in the field of financial education would be extremely useful.

### 3. Market Drivers toward a Pan-European capital market

The innovative SMEs may develop in case of availability and access to appropriate forms of financing – most often private equity and venture financing. The financing of these companies by the creditors is considered an unattractive business due to the high transaction costs and low returns.

Among the main barriers to the international expansion of EU equity and venture capital funds (EVCFs) are the limited size of these funds. The equity and venture capital market in EU is insufficiently developed and represents around 1/4 of that in the US. In the EU, the SMEs rely mainly on bank lending which amounts to about 80% of attracted funds, while only 2% are the funds attracted through equity and venture capital funds (in the US this latter value is over 15%). The weaknesses

in the sector relate to difficulties in raising capital by institutional investors, the quality of investment opportunities and the fragmentation of the equity and venture capital markets in EU, as well as the domination of bank financing over all other forms of SME financing. The EU capital markets are falling in global ratings, sliding from second place behind US to third place behind US and Asia. Stock market capitalization is only 65 % of EU GDP, while in US it is 136% of GDP.

The activities of the EVCFs are concentrated in several EU member states, namely in the UK (where these investments reach 2% of GDP), Germany, Sweden, Denmark, the Netherlands, France and Spain. A correlation has been found to exist between investments in equity and venture capitals and the level of competitiveness of countries.<sup>3</sup>

One of the main distinctions between the US and the EU, is that in the EU EVCFs finance companies by extending smaller amounts than that in the US. The average value of investments in technologically innovative companies in EU is EUR 0.9 million against EUR 6.1 million in the US. The American EVCFs are usually characterized by extending bigger volumes of capital to the target companies, investing in the initial stages of their development and greater participation in their subsequent development. The significance of the investments in equity and venture capitals is supported by the fact, that in US these investments as financing tool reach 0.14% of GDP, while in EU the average value is 0.03% (Kelly, 2011). According to data from the European Venture and Equity Capital Association (EVCA), 98% of the EVCFs administer portfolio companies with assets below the threshold of EUR 500 million, envisaged in the Alternative Investment Fund Managers Directive (AIFMD). The lack of sufficient investments in seed stage is due to the relatively low return from these investments in EU (the rate of return of 10-years' investments in all forms of venture capital reached 6.3%, while in the US it is 26%<sup>4</sup>). This lack is partially compensated by the various public financial instruments under EU Programmes or by encouraging the establishment of public-private partnerships.

Among the main problems in the extension of equity and venture capital in the EU can be outlined the lack of sufficiently large institutional investors active on the equity and venture capital markets (as pension funds, university foundations etc.) due to the low levels of return from these investments. It can be explained by the small size of this market segment, the weak experience of the majority of the EVCFs, the low activity of large corporations in this segment, the risks of double taxation of incomes in some member states etc.

In the US, approximately 75% of equity and venture capital investments are directed toward two sectors: IT and biotechnologies due to the higher

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<sup>3</sup> According to the Global Competitiveness Index of the World Economic Forum.

specialization of the EVCFs in these two fields and over 10% are seed investments. The higher risk in this stage leads to greater variability in the expected rate of return. One of the weaknesses in the innovation system in the EU is the insufficient link between public and private innovations, which is further combined by low investments in private R&D. Within EU highest innovation activity is observed in Sweden, followed by Denmark, Finland and Germany. These countries attain a high degree of commercialization of the technological know-how in terms of issued patents and realized incomes abroad.

The supply of equity and venture capitals in domestic and trans-border context in EU is positively tied with well-functioning tax and legal framework, regulating fundraising and investments. The limited opportunities of the pension funds in Europe to invest venture capitals practically exclude this group of institutional investors from the venture capital markets. It is only in the UK and some of the Scandinavian countries (Sweden) and also the Netherlands, where the pension funds use occupational and voluntary schemes for investing on this market. As compared to Europe, in the US the pension funds after 1979 are entitled to apply the so called "prudent man rule" and to invest approximately 15% of the assets under management in EVCFs, thus turning into a major institutional investor in venture capitals.

Another significant problem in Europe relates to the limited exit opportunities for EVCFs due to the lack of sufficiently liquid stock markets for trade in shares of innovative SMEs with small capitalization (small cap stock markets). The fragmentation of the EU capital markets further restricts liquidity and thus trade sales remain the preferred exit option for the EVCFs in Europe, while IPOs of shares of portfolio-companies represent only around 13%.

Based on the above-outlined market problems at EU level, the following market-driven initiatives for the creation of European CMU can be summarized.

- One important market driver for the creation of European CMU is the expansion of the equity and debt market segments as venture capital, private equity investment, public equity issuance, IPOs, corporate bond issuance, credit intermediation by non-bank financial firms as leasing companies or consumer finance companies.

In the EU, the governments are extremely active users of the bond markets and large companies are also fairly active – in 2011 only 55% of the debt of large German companies was in the form of bonds, while in the US the figure was 99%. Europeans lack a strong equity culture. Equity is more heavily taxed than debt and one policy change is to remove the tax discrimination against equity. Bonds markets should be also subject to transparency rules with appropriate delayed reporting mechanisms as in equity markets. Bond trading in EU is mainly executed on OTC basis via electronic platforms (95% on OTC and only 5% on regulated

markets or multilateral trading facilities, according to FESE, 2014). Equity plays a larger role in financing US economy than in Europe. US stock of listed equity averaged 116% of US GDP, compared to around 69% in Europe. OECD evidence shows that IPOs around the world and in Europe show a systematic long-term downturn trend. Throughout 2008-2012 only 6 out of the top 26 IPO markets were from EU and they produced fewer IPOs than Canada and Australia put together. Since the beginning of the crisis European IPO issuances have been made on the American private placement market, which according to OECD holds 1/3 of European placements (Robert Schuman Foundation, 2014).

- The CMU can be boosted also by the development of the segment of securitized bank loans by taking a bundle of bank loans and selling them to special purpose vehicle (SPV), which then issues securities and sells them to investors.

The default rates on EU securitization between mid 2007 and mid 2014 were only 1.6%, while the equivalent for US was 19.3%. The new regulation in Europe requires insurance companies, which are main investors in securitized loans to hold extra capital if they buy these assets. Asset-backed securities (ABS) could potentially be used to repackage risks by being bundled with specific classes of assets (as small business loans etc.). ABS are placed off-balance sheet, thus freeing banks' regulatory capital and allowing them to use other assets as collateral to lend more to companies and households. On the other side, covered bonds, linked to real estate assets and public sector loans remain on the banks' balance sheets, but being similar to securitization enable risk diversification. The potential for the development of the European securitization market is estimated to be between EUR 3-4 trillion. High quality securitization that is based on the Prime Collateralized Securities initiative is expected to promote quality, transparency, simplicity and standardization through the asset-backed securities market in Europe.

- Initiatives should be undertaken at market level for the boost of securities trading in secondary markets and the integration of clearing and settlement infrastructure.

The plans of 10 EU member states to introduce the financial transactions tax (among which Germany and France) could reduce liquidity and make the EU capital markets less attractive, thus an agreement on the common practices, principles and bands within which the tax rate is set would create a more level playing field. The EU secondary markets have not reached their potential in terms of creating a truly integrated liquidity pool. Equity markets saw increased market fragmentation accompanying the growth of unregulated dark pools and the opacity of OTC data. This leads to less efficient price discovery process and less efficient allocation of

capital. Another risk could come from the new ways of accessing the markets (ex. crowd-funding) where it is important to avoid fraud that would erode public confidence. The focus should be on measures to increase the neutrality, transparency and integration of trading flows in all asset classes and ensuring cross-border surveillance of the multi-venue trading structure. In settlement the cost of transferring securities from one member state to another are largely prohibitive even if the same security is traded in different countries. Banks and brokers need to connect either directly or via a third party to settle their transactions. These costs are likely to be passed along the chain from the custodian to the broker and then to the end-investors. In clearing, multiple CCPs have emerged to serve local markets. Competition between execution venues has reduced direct costs of trading. The need to clear trades via CCPs and the participation of trade counterparties in different CCPs creates a need for interoperability between CCPs and non-discriminatory access to relevant trading venues.

- The trading methods at the EU stock exchanges should increase the liquidity of smaller shares.

Certain market practices in trading of shares as dark pool trading rules could also help create greater visible liquidity for smaller shares. For the EU a preferred scenario would be the creation of particular segments at the stock exchanges for trade in SMEs shares with small capitalization (small cap market) and high growth potential. The creation of such pan-European trading platforms for trade in shares of high-tech SMEs would lead to the attainment of critical mass and attraction of companies, investors, financial intermediaries and consultancy firms. The listing of SMEs' shares on such platforms would increase their visibility and an important investor in their shares would become the funds of funds (FFs) through the various EU public programmes. Such FFs may reach certain level of specialization on regional/niche markets for SMEs and to attract other investors as private equity funds, UCITs etc.

- Further market driver should be the development of the European derivative markets since regulated markets ensure that all derivative trades are cleared through central counterparties (CCP). Transparency is a vital element of well-functioning derivative markets and leads to mitigation of counterparty risk, increase of liquidity, sound margining and risk control requirements.

Last but not least, the global consolidation among market infrastructures, the increasing interconnection among financial markets and financial institutions and the newly developed trading technologies are significant market drivers changing the structure of the financial markets in Europe. The increased

competition due to the regulatory intervention at pan-European level is leading to lower transaction costs for investors.

#### 4. Conclusion

Based on the analysis of the institutional and market initiatives for the creation of European CMU, the expected benefits from CMU can be summarized as follows:

- Finance for the economy and enhancing economic resilience – more non-bank finance is needed but EU is much more bank-centred and it relies on banks for roughly over 70% of SMEs funding, while in the US companies turn to banks for only 30% of their finance. The CMU will provide a useful supplementary source of finance that would reduce the volatility and cyclicity of bank financing.
- Shock absorption – it is high when funding is provided in the form of equity by reducing and controlling the links between banks and non-banks and making the markets more transparent. The widening of the distribution of risks may mitigate the build-up of systemic risks.
- Competitive markets and boost of economic growth – there would be a scope for open markets for SMEs because market-based financing enriches the ecosystem of equity and bond analysts, business angels, venture capitalists, hedge fund investors and this is expected to lead to a greater discipline in the allocation and use of capital. There is a strong correlation between the depth of the capital markets and economic growth (New Financial, 2014).
- Increased capital markets integration – the CMU should foster deeper and more liquid financial markets and possibly higher levels of cross-border investments, given lower transaction costs and the elimination of exchange rate risk. More integrated financial markets should increase the efficiency of capital from the perspective of allocation and allow for higher diversification of shocks, mitigating their impact on consumption.
- Expectations for increased harmonization or convergence of tax policies in the EU member states – the preferred approach would be toward equality of tax treatment for debt and equity and implementation of harmonized reporting standards. This approach may also require reconsideration of any new tax charges (as the financial transactions tax), which may distort the efficient functioning and the deeper integration of the EU capital markets.
- In conclusion, the potential benefits from CMU are significant, yet the efforts for its attainment may prove to be substantial since they will require considerable institutional changes in the administrative, legal, tax and other

fields and further adaptation of the market players to them, which may increase the costs for regulatory compliance and conformity.

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